| Franchise Tax Board ANALYSIS OF ORIGINAL BILL | | | | | | | | |
|--|---|--|--|---|--|--|--|--|
| /Leiber | Analyst: | Gail Hall | Bill Number: | AB 1147 | | | | |
| See Legislative History | Telephone: | 845-6111 | Introduced Date: Fel | oruary 23, 2007 | | | | |
| _ | Attorney: | Patrick Kusia | k Sponsor: | | | | | |
| SUBJECT: NOL Deduction/Unused Losses Of Bioscience Company May Be Sold To Another Corporation | | | | | | | | |
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| This bill would allow a bioscience corporation to sell unused losses. | | | | | | | | |
| PURPOSE OF THE BILL | | | | | | | | |
| The authors' staff has indicated that the purpose of the bill is to allow taxpayers engaged in bioscience business activities a tax benefit that provides an additional source of funds that can be reinvested in employees and equipment. | | | | | | | | |
| EFFECTIVE/OPERATIVE DATE | | | | | | | | |
| As a tax levy, this bill would become effective immediately upon enactment and would specifically allow for the sale of unused net operating losses (NOLs) for taxable years beginning on or after January 1, 2008. The purchaser of the unused NOLs would be able to deduct those losses for taxable years beginning on or after January 1, 2010. | | | | | | | | |
| POSITION | | | | | | | | |
| Pending. | | | | | | | | |
| ANALYSIS | | | | | | | | |
| FEDERAL LAW | | | | | | | | |
| ars is called an NO taxpayer's allowed | L and is refe deductions | erred to above exceed their g | as unused NOLs. An or ross income for that year | perating loss ar. Federal | | | | |
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| | | | Pepartment Director | Date | | | | |
| NA | | _NP | | | | | | |
| | See Legislative History NOL Deduction/Un Corporation allow a bioscience THE BILL aff has indicated th ness activities a ta nployees and equi PERATIVE DATE his bill would become le of unused net on the purchaser of eginning on or after ars is called an NO taxpayer's allowed a general, that an No | See Legislative History Telephone: Attorney: NOL Deduction/Unused Losse Corporation THE BILL aff has indicated that the purponess activities a tax benefit thamployees and equipment. PERATIVE DATE his bill would become effective le of unused net operating loss 3. The purchaser of the unuse eginning on or after January 1, er has an operating loss for the ars is called an NOL and is reference taxpayer's allowed deductions in general, that an NOL can be of the control of the co | Analyst: Gail Hall See Legislative History Attorney: Patrick Kusia NOL Deduction/Unused Losses Of Bioscience Corporation Attorney: Patrick Fusia NOL Deduction/Unused Losses Of Bioscience Corporation THE BILL aff has indicated that the purpose of the bill is ness activities a tax benefit that provides an amployees and equipment. PERATIVE DATE his bill would become effective immediately uple of unused net operating losses (NOLs) for B. The purchaser of the unused NOLs would eginning on or after January 1, 2010. Attorney: Patrick Kusia NOL set In Section Corporation to sell unused The bill is ness activities a tax benefit that provides an amployees and equipment. PERATIVE DATE his bill would become effective immediately uple of unused net operating losses (NOLs) for B. The purchaser of the unused NOLs would eginning on or after January 1, 2010. | Analyst: Gail Hall Bill Number: See Legislative History Attorney: Patrick Kusiak Sponsor: NOL Deduction/Unused Losses Of Bioscience Company May Be Sc Corporation NOL Deduction/Unused Losses Of Bioscience Company May Be Sc Corporation Attorney: Patrick Kusiak Sponsor: NOL Deduction/Unused Losses Of Bioscience Company May Be Sc Corporation Allow a bioscience corporation to sell unused losses. THE BILL Bif has indicated that the purpose of the bill is to allow taxpayers engness activities a tax benefit that provides an additional source of funnployees and equipment. PERATIVE DATE In bill would become effective immediately upon enactment and would be of unused net operating losses (NOLs) for taxable years beginning. The purchaser of the unused NOLs would be able to deduct those eginning on or after January 1, 2010. Attacked the purpose of the bill is to allow taxpayers engness activities a tax benefit that provides an additional source of funnployees and equipment. PERATIVE DATE In the purpose of the unused NOLs would be able to deduct those eginning on or after January 1, 2010. Department Director | | | | |

for Selvi Stanislaus

Internal Revenue Code (IRC) section 382 was added to the Internal Revenue Code in 1954 to guard against "trafficking of NOL carryovers." That section has been amended numerous times since, each time to further tighten the rules preventing trafficking in these NOL carryovers. When a corporation acquires another corporation with NOLs, IRC section 382 limits the amount of acquired NOL the buyer may deduct on its tax return each year. The purpose of this rule is to make NOLs a neutral factor in a corporate acquisition. Prior to the limitation, corporations with large NOLs were being purchased by corporations with large taxable incomes because the acquired corporation's NOLs could be used to reduce the buyer's taxable income.

Current federal law lacks provisions that allow a corporation to sell an NOL to another corporation.

STATE LAW

In general, a California taxpayer calculates its NOL in accordance with federal rules. One important difference is that California does not allow the carryback of NOLs. Depending on the type of taxpayer or amount of a taxpayer's income, the amount of NOL that is eligible to be carried forward and the numbers of years it can be carried forward varies from 9 years to 15 years.

Current state law lacks provisions that allow a corporation to sell an NOL to another corporation.

THIS BILL

This bill would add a new rule that would allow a "qualified seller" to sell NOLs to a qualified buyer.

A *qualified seller* would mean a bioscience corporation that satisfies the following:

- Is based in California.
- Spends at least 50% of its annual expenses for research and development relating to bioscience products.
- Is able to substantiate the following in a form and manner as requested by the Franchise Tax Board:
 - 1. Has not had positive net income from product sales for any year in the last five years at the time of the submission of the application to sell.
 - 2. Is headquartered or incorporated within the state.
 - 3. Has raised 400% of the tax value of the proposed NOL sale from public or private funding sources in the prior 24 months.

A *qualified buyer* would mean any company that employs 500 or more employees in California.

Other Provisions Of The Bill

- The tax value of all NOLs that may be sold by qualified sellers for each tax year would be limited to \$100 million.
- The tax value of NOLs that may be sold by any qualified seller for each taxable year would be limited to \$10 million.
- A qualified seller would be required to sell the NOLs for at least 75% of the tax value of the NOL.
- The revenues received by the seller for the sale of an NOL would be excluded from the gross income of the qualified seller for state tax purposes.
- The qualified seller and buyer would be required to apply to Franchise Tax Board for the purchase and sale of the NOLs.
- NOLs purchased by a qualified buyer would be required to be used only as a deduction from gross income derived from bioscience products. The buyer would be required to begin using the NOLs within five years of purchase.

IMPLEMENTATION CONSIDERATIONS

- 1. The bill lacks definitions of "bioscience company," "bioscience products," "tax value," and "based in this state." Without these definitions, and in particular because the department lacks the necessary expertise and clear legal authority (via a legislative rulemaking delegation) to supply an enforceable definition for these terms, it cannot be determined if a sale of an NOL would qualify. In addition, undefined terms can lead to disputes between taxpayers and the department.
- 2. The bill would require the qualified buyer to employ at least 500 employees in California; however, the bill is silent about whether this test must be met on the sale date, on an ongoing basis as the NOLs are applied, or something else, or whether the 500 employees must be retained after the purchase or are simply measured on the purchase date. The 500 employee requirement in particular would be difficult to measure if a date other than an Employee Development Department quarterly filing date were used because the number of employees in large corporations is a constantly changing amount.
- 3. The bill would require the seller and buyer to apply to the department for the purchase and sale of an NOL. However, the bill lacks a grant to the department of authority to create rules or specify what criteria the department is to use in approving or denying a sale. This may result in disputes between the department, taxpayers, the Board of Equalization, and the courts. In addition, although the bill allows for the sale of NOLs beginning on January 1, 2008, there are currently no procedures for processing and approving the purchases, and the department could not approve sales immediately. The author may want to consider: (1) a delayed implementation date and (2) an appeals process if an application is denied.

- 4. Although the bill would limit the amount of NOL deductions the purchaser may use to offset gross income derived from bioscience products, the bill lacks specificity about how to determine that amount. This may require corporations to make special calculations to separate income streams, perhaps similar to the calculation that is required for certain enterprise zone incentive provisions.
- 5. The bill specifies that the purchaser must begin using the NOL within five years of purchase; however, the bill lacks specificity about whether the sale of the NOL would impact the carry forward period. Without clarification, the department would assume that the remaining NOL carryover period for the seller corporation would apply to the purchaser. If this is not the intent, it is possible that a buyer could purchase an NOL with only three years remaining in its carryover period and possibly either get an extended new period or be stuck with the three-year period remaining if the seller were to use the NOL itself. Clarification of this issue would prevent disputes between taxpayers and the department.
- 6. It is unclear what would happen if a corporation sells an NOL, and the NOL is partially or completely disallowed in a subsequent audit by the department. It is recommended that the language clarify whether the seller or purchaser or both would be liable for any assessments resulting from adjustments to the NOL.
- 7. It is unclear how the bill would apply to unitary groups. In general, NOLs belong to the separate entities within the group. When defining a "qualified seller" and "qualified buyer," the bill lacks specifics on whether it applies to the "taxpayer" buying or selling the NOL. The present language could allow a unitary group (or any single member of that group) to purchase an NOL if any one affiliate is a "qualified buyer."

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- 1. The bill would allow unlimited sales of the same NOL. If this is not the intent of the author, amendments would be necessary.
- 2. The bill would exclude from the seller's income the proceeds from the sale of NOLs, but would allow the buyer of the NOL to deduct the purchase price. If this is not the intent of the author, amendments would be necessary.

LEGISLATIVE HISTORY

AB 1370 (Hayashi/Mullin/Lieber, 2007/2008) would allow a personal income and corporate taxpayer engaged in bioscience activities a 20-year NOL carryover. AB 1370 is currently in the Assembly Revenue and Taxation Committee

AB 2270 (Houston, 2005/2006), AB 2230 (Corbett, et. al., 2003/04), and SB 1572 (Alpert and Morrow, 2003/04) were similar bills that would have provided special tax benefits to bioscience companies, including the ability to sell unused NOLs to other companies. AB 2270, AB 2230, and SB 1572 were held in their respective appropriation committees.

AB 743 (Mullin, 2003/2004) would have allowed corporations that have NOLs from the development or marketing of biomedical products to transfer the NOL to another corporation. AB 743 failed to pass from the house of origin by the Constitutional deadline.

AB 1654 (Houston, 2003/2004) would have allowed corporations to sell NOLs to another corporation. AB 1654 failed to pass from the house of origin by the Constitutional deadline.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. These states lack provisions allowing bioscience corporations to sell NOLs to other corporations.

New Jersey allows high-technology companies to trade NOLs and research and development tax credits to other entities through a certificate program in exchange for private financial assistance from the entity acquiring the surrendered tax benefits. The New Jersey Economic Development authority is authorized to approve the transfer of no more than \$60 million for each fiscal year on or after 2005.

Hawaii allowed certain high technology businesses, including biotechnology businesses, to sell unused NOL carryovers to other taxpayers. The Department of Taxation approved all sales. Sales were allowed from January 1, 2001, to December 31, 2003.

FISCAL IMPACT

The department is unable to determine the costs to administer the bill until the implementation concerns have been resolved. If the department is required to implement a sales approval process, there could be significant costs depending upon the level of audit and approval activity prior to the approval of the sale.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

| Revenue Impact of AB 1147 Enactment Assumed After June 30, 2007 | | | | | | | | |
|---|---------|---------|---------|---------|---------|--|--|--|
| (\$ in Millions) | | | | | | | | |
| | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | | | |
| Revenue Impact | 0 | +\$1.5 | -\$80 | -\$190 | -\$115 | | | |

This bill would result in revenue losses in taxable years beginning on or after January 1, 2010, because that is when a purchaser may begin deducting purchased NOLs.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion:

Using company-level data on the net incomes of bioscience corporations, the projected tax value of unused NOLs in 2007 exceeded the \$100 million limitation. Therefore, the tax value for this year was constrained to equal \$100 million. The amount of unused NOLs that exceeded the tax value of \$100 million was assumed to be available for sale in subsequent years. Additionally, the amount of unused NOLs that were not sold in 2007 due to the per seller limitation of \$10 million were assumed to be carried forward and used in subsequent years. The tax value was calculated using the statutory 8.84% tax rate for corporations. The tax value of NOLs carried forward plus the total tax value of NOLs generated in subsequent years were projected to exceed \$100 million for 2008 and subsequent years and were constrained to equal \$100 million. Qualified buyers would accumulate \$300 million of NOLs purchased in 2008, 2009, and 2010 that could be potentially used in 2010 (the first year qualified buyers are allowed to use the purchased NOLs) and after.

It was assumed that 80% of the NOLs purchased in 2008, 2009, and 2010 by qualified buyers would be used in 2010 and the remaining 20% in 2011. This resulted in \$240 million of tax values in 2010 ($$300 \text{ million} \times 80\%$) and \$60 million of tax values in 2011 ($$300 \text{ million} \times 20\%$).

It was assumed that 5%, 3%, and 1% of the unused NOLs in 2008 would have been used in 2009, 2010, and 2011, respectively, even if this bill were not enacted. This assumption would result in offsetting gains of \$5 million for 2009 ($5\% \times 100 million), \$3 million for 2010 ($3\% \times 100 million), and \$1 million for 2011 ($1\% \times 100 million). The same percentages were used to estimate the offsetting revenue gains from the sale of unused NOLs in 2009 and 2010. The total offsetting gains for 2010, for example, would equal \$8 million (5% of the \$100 million NOLs for 2009 + 3% of \$100 million NOLs for 2008).

The net revenue impact of the bill for 2010 would be a loss of approximately \$232 million (\$240 million minus the offsetting gain of \$8 million). This amount was converted to a fiscal year basis and spread to fiscal years 2008-09, 2009-10, and 2010-11.

LEGAL IMPACT

This bill would require that the seller be "based in California" and a company to have 500 employees in California before it may purchase NOLs. These requirements may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

ARGUMENTS/POLICY CONCERNS

- The bill would provide a tax benefit for certain bioscience corporations that would exclude other bioscience business entities (e.g., noncorporate partners of partnerships, limited partnerships). Thus, the bill would provide differing treatment based solely on entity classification or form of organization.
- 2. The bill would create federal/state differences because the seller would be required to report the income from the sale of the NOL on the federal corporate tax return, but not the state tax return. This conflicts with the general policy of federal/state conformity.
- 3. Internal Revenue Code section 382, to which California conforms, has stringent requirements regarding the utilization of NOLs following any "ownership change" of greater than 5%. These federal rules have evolved over the past 35 years in response to perceived trafficking in NOLs by corporations that have acquired loss corporations for the primary purpose of utilizing the locked NOL tax benefits inherent in such corporations. In contrast to that long-standing federal policy, to which California has long conformed, the bill would specifically permit such selling in NOLs.
- 4. The Congressional Joint Committee on Taxation, on the subject of transferable NOLs, has expressed concern that allowing the transfer or sale of NOLs would effectively use the tax system to subsidize corporate losses. The Committee reasoned that the NOL provisions are intended to perform an averaging function by reducing the distortions caused by the annual accounting system for any particular taxpayer. Conversely, if carryovers are transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of NOLs, the carryover provisions become a mechanism for partial recoupment of losses through the tax system.
- 5. The bill excludes the revenues received by the seller for the sale of NOLs from taxable income, but appears to allow a deduction to the buyer for the purchase of the NOL. This provides a double tax benefit to the seller and buyer for the same transaction.

LEGISLATIVE STAFF CONTACT

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